Civeo Industries (CVEO)

Share Price:	$3.14	Revenue:	964	P/E:	3.0
Market Cap:	335	EBITDA:	324	P/TBV:	0.4
Enterprise Value:	871	EBIT:	153	EV/EBIT:	5.7
Cash:	242	Net Income:	110	Net Debt/EBITDA:	1.6
Debt:	775	FCF:	(0)	EBIT/Interest:	7.2

Background

Civeo was spun off from Oil States International (NYSE:OIS) in May 2014. The Company provides permanent, long-term and temporary accommodations to workers, often referred to as “man camps”, largely to Canadian oil sands projects and the Australian metallurgical coal (“met coal”) mining industry. Aside from lodging, it also provides catering and food services, housekeeping, recreation facilities, laundry, water and wastewater service, power generation, and communications.

While the Company is the largest player among 3rd party provision operators in Canada and Australia, the majority of the accommodations market remains owner-operated.

Thesis

1. **Share price is down over 85% YTD, driven by two one-day drops of over 50% following news that were largely unrelated to fundamentals.**

The first drop occurred on September 29 2014, after the Company announced that it would not convert to a REIT structure, and instead would re-domicile to Canada. Share price declined 50% in one day, from $25.47 to $12.84. While the idea of a REIT instrument was suggested by certain activist investors, such was never the initial plan of the management. Importantly, despite a 50% drawdown in share price, there were no changes at all to the Company’s fundamental business. In fact, as the Company explained in detail, the re-domicile was accretive to the bottom-line as it would generate substantially higher tax benefits than a REIT conversion.

The second drop occurred on December 30 2014, following the suspension of quarterly dividends and lowering of 2015 guidance figures. Share price again declined 50% in one day, from $8.27 to $3.92. Prior to the announcement, management had repeatedly affirmed, even on the previous earnings call, its commitment to becoming a yield vehicle. As such, the dividend suspension was considered a surprise. However, the dividend suspension was less related to financial distress (the payout ratio was a comfortable 44%) but a move to redirect cash flow to pay down debt, which would strengthen the Company’s balance sheet in anticipation for a tougher operating environment. Furthermore, the updated guidance figures merely quantified what was known qualitatively since the previous earnings call and was not indicative of a change to its business fundamental.

While the share price slide has occurred amidst a macro backdrop of declining oil prices, the large one-day price movements followed news that were more related to mismanaged shareholder expectations on yield rather than business fundamentals. With the stock currently yielding 0%, further negative price shocks related to yield are unlikely.

2. **Company is currently priced for bankruptcy, yet reasonably solid financials and active steps taken by management to conserve cash flow minimize the risk of financial bankruptcy in the short term.**

   As of September 31 2014, book value per share stands at more than $11 per share, while tangible book value is over $8 per share. Even if one were to write down all accommodation assets by half, tangible book value per share would be ~$4 vs. the current price of ~$3.5.

   The Company, however, is only moderately levered, with no debt maturity before 2019. With $765m long-term debt and $241m of cash, against a projected 2015 EBITDA of $135-160m. Even at the low end of projections and assuming no debt paydown, net debt/2015e EBITDA would still be under 4.0x, well below its peers in the oil servicing space. Interest coverage is strong at ~7x 2015e EBITDA/interest.

   While there is concern that the decline in projected EBITDA could cause the Company to breach its maximum covenant leverage of 3.5x net debt/EBITDA in Q3 2015, the Company has already undertaken several measures that mitigate such risk. First, it has suspended dividends, significantly reduced headcount and planned capex, which yield an estimated ~$300m of cashflow savings for FY2015 versus FY2014. Management intends to utilize part of the cash savings and existing cash balance to accelerate debt pay down. Second, the Company is under discussions with creditors to refinance its debt in conjunction with its re-domicile. Last but not least, the Company has access to $531m of 5-year revolving credit. Given the above, the risk of a breach-induced default is very low in the short term, and the Company should have sufficient runway to wait for a recovery.

3. **Despite the recent 50+% drop in oil prices, the Company's downside is limited by take-or-pay contracts in the short term, and cost structure has been rightsized.**

   While the decline in oil prices has caused deferral of new Canadian oil sands projects construction, and thus reduced demand for accommodation, the Company still has 35-40% of its rooms on take-or-pay contracts for 2015 in Canada. These contracts contain termination fees with make-whole clauses. Oil sands projects are developed with a long-term break-even in mind, since they have high upfront costs that could exceed $10 billion, but steady production lives of up to three decades. As a result, projects that are under construction or in the production phase are very unlikely to be suspended despite short term oil price volatility, and will still require accommodation for its labor force.

   As occupancy rates are forecasted to decline <u>from 86% in LTM 2014 to 44-47% in 2015</u>, and revenues from <u>$980 to $560-600m</u>, the Company has swiftly taken active steps to right-size the business, including reduction of headcount in Canada by 30%, temporary closure of Athabasca Lodge, and permanent closure of Lakeside Lodge. As a result, 2015 operating costs are expected to fall by >35% in 2015, including >20% fall in SG&A expenses. Similar steps are being taken in Australia, where occupancy is also projected to decline moderately. With a new cost structure, the Company is well-equipped to withstand a period of reduced occupancy. Even if we assume low-end 2015 guidance of $135m EBITDA (25% margin on $540m revenue, compared to LTM 2014 37.5% margin on $982 revenue), interest expense of $25m, and capex of $80m, the Company will still have a positive free cash flow of $30m.

4. **The Company's business is driven by new construction, and thus highly levered to improvements in oil producers' sentiment and confidence.**

As of January 2015, Canadian oil sands companies have deferred as much as $60 billion of capex in face of oil price volatility and uncertainty. *Even without a return to $90 oil, if volatility subsides* and producers have a more confident view of longer-term price levels, be it $60 or $70 oil, the pent up capex will likely return for projects that can breakeven at those levels. Furthermore, in the long term, there are still tailwinds for Canadian oil sands, including strong demand from U.S. refineries which are mostly designed to handle heavy crudes, and continuous development of new technologies such as in-situ production which will reduce the breakeven cost of oil sands production, which currently can be as low as $60-65[1].

The return of deferred capex will be an immediate boon to the Company, as its business is highly levered to new builds. New construction projects require as much as five times the labor as the production stage. As such, new construction will significantly improve occupancy rates and provide growth prospects for new lodging. Using conservative back of envelope assumptions, a recovery to $1 billion revenue (LTM $981m) on 30% EBITDA margin (historically 35-45%), and a 6x EV/EBITDA margin would indicate a share price of ~$12, over 200% upside. A recovery in the Australia met coal markets, further EBITDA margin recovery, return of quarterly dividends, debt pay down, and growth opportunities will also bring further upside. In such an upside scenario, a $1.2 billion revenue with 40% EBITDA margin, 7x EV/EBITDA would indicate a share price of ~$26, over 550% upside.

[1] http://business.financialpost.com/2014/02/20/oil-sands-retain-competitive-edge-over-u-s-tight-oil/?__lsa=37a0-9818